

E-FILED on 7/11/05

IN THE UNITED STATES DISTRICT COURT  
FOR THE NORTHERN DISTRICT OF CALIFORNIA  
SAN JOSE DIVISION

THOMAS FALLON, an Individual, ROBERT  
PUETTE, an Individual, CARL REDFIELD, an  
Individual, RICK TIMMINS, an Individual, on  
behalf of each, individually, and on behalf of the  
general public,

Plaintiffs,

v.

LOCKE, LIDDELL & SAPP, LLP, a Texas  
limited professional partnership, and DOES 1  
through 100,

Defendants.

Case No. C-04-03210 RMW

MOTION DENYING WITHOUT PREJUDICE  
STAY OF PROCEEDINGS

[Re Docket No. 37]

Defendant Locke, Liddell & Sapp moves to stay further proceedings in this case. Plaintiffs oppose the motion. The motion was heard on July 1, 2004. The court has read the moving and responding papers and considered the parties' arguments. For the reasons discussed below, the court denies without prejudice defendant's motion to stay.

**I. BACKGROUND**

Plaintiffs Robert Puette, Carl Redfield, Rick Timmins, and Tom Fallon are individuals, all of whom reside within the County of Santa Clara, California. Compl. ¶¶ 10-13. Defendant Locke, Liddell & Sapp, LLP ("LL&S") is a Texas law firm based in Dallas, with offices in Austin, Houston, and New Orleans. *Id.* at

¶ 14. Plaintiffs allege that LL&S renders legal services to clients in the State of California, including plaintiffs.  
*Id.*

In 1999, defendant learned that Ernst & Young ("E&Y") was looking for a tax opinion for a new tax strategy called the Contingent Deferred Swap strategy ("CDS strategy") that E&Y had been promoting. Mot. to Dismiss at 2. This strategy was intended to provide participants with a tax savings by converting ordinary income into capital gains to obtain a one year deferral of taxes. *Id.* E&Y contacted Brent Clifton, an attorney at LL&S, to obtain his preliminary opinion on whether the International Revenue Service ("IRS") would approve of the CDS strategy. *Id.* at 3. Clifton reported back to E&Y that he could provide a "should" opinion on the CDS Strategy. *Id.* Clifton made evaluations for defendant's customers in the form of opinion letters. *Id.*

Plaintiffs entered into contracts with defendant "concerning the nature and scope of LL&S's engagement" that would provide plaintiffs with a legal analysis of E&Y's CDS strategy. Compl. ¶ 18. The letters sent by defendant to plaintiffs stated that defendant has a special understanding of investment; that an opinion would be provided of the "principle [sic] tax consequences of [plaintiffs'] investment"; that defendant would review all of plaintiffs documents and discuss the investment with plaintiffs and give its opinion of the tax consequences; that investment should provide plaintiffs with "substantial tax benefits"; and that each plaintiff would pay \$50,000 for the opinion letter. *Id.* Plaintiffs each invested between \$6 million and \$20 million to acquire a limited partnership interest in the CDS strategy sold to them by defendants. *Id.* at ¶¶ 10-13. However, plaintiffs allege that defendant never met nor spoke with them concerning their investment strategies. *Id.* at ¶ 19.

Plaintiffs claim that defendant had decided to provide plaintiffs with "favorable tax opinion[s]" before plaintiffs ever retained it as a legal advisor. *Id.* at ¶ 20. The opinion letters provided a detailed explanation of tax shelters and distinctions between lawful tax avoidance and unlawful tax evasion. *Id.* at ¶ 21. The opinion letters specifically stated that "partnership should be respected [by the taxing authorities] as a partnership for federal income tax purposes." *Id.* The letters claimed to rely on "substantial authority" for this opinion. *Id.* Plaintiffs allege that this wording communicated to plaintiffs a sense of confidence on defendant's part that the strategy would be effective. *Id.* Additionally, the letter failed to mention adverse tax law about which defendant allegedly was aware. *Id.* at ¶ 22.

On May 28, 2002, the IRS issued a notice declaring that the CDS strategy was "not allowable." Mot. to Dismiss at 3. It advised individuals who had used this strategy to file amended returns. Watkins Decl. Ex. A. It is not currently known how plaintiffs responded to the IRS notice, but plaintiffs have not yet received a deficiency notice outlining their tax liability for using the CDS strategy. Mot. to Dismiss at 3. The IRS has not yet assessed the penalties, if any, for which plaintiffs will be responsible. *Id.*

On June 15, 2004, plaintiffs filed a complaint against defendant alleging breach of contract, breach of fiduciary duty, professional negligence, negligent misrepresentation, intentional misrepresentation, and unfair business practices under California Business and Professions Code section 17200. Compl. ¶¶ 29, 32-37, 41-43, 46-48, 51-56.

## II. ANALYSIS

### A. Discretion to Stay Further Proceedings

Defendant moves to stay these proceedings pending resolution of plaintiffs' tax liability. "District courts ordinarily have authority to stay proceedings." *Landis v. N. Am. Co.*, 299 U.S. 248, 254 (1936); *see Clinton v. Jones*, 520 U.S. 681, 706-07 (1997) ("District Court has broad discretion to stay proceedings as an incident to its power to control its own docket."); *Bureerong v. Uvawas*, 167 F.R.D. 83, 87 (C.D. Cal. 1996). "Even if the other proceedings do not control the outcome in the action before the court, a stay may be appropriate." *Agcaoili v. Gustafson*, 844 F.2d 620, 624 (9th Cir. 1988). The Ninth Circuit held that:

"[a] trial court may, with propriety, find it is efficient for its own docket and the fairest course for the parties to enter a stay of an action before it, pending resolution of independent proceedings which bear upon the case. This rule applies whether the separate proceedings are judicial, administrative, or arbitral in character, and does not require that the issues in such proceedings are necessarily controlling of the action before the court."

*Leyva v. Certified Grocers of California, Ltd.*, 593 F.2d 857, 863-64 (9th Cir. 1979) *cert. denied*, 444 U.S. 827 (1979); *See Kerotest Mfg. Co. v. C-O-Two Fire Equip. Co.*, 342 U.S. 180, 184 (1952) ("Necessarily, an ample degree of discretion, appropriate for disciplined and experienced judges, must be left to the lower courts."); *Mediterranean Enters., Inc. v. Ssangyong Corp.*, 708 F.2d 1458, 1465 (9th Cir. 1983). It is clear that this court may employ its discretion in determining whether a stay of further proceedings is appropriate in this action. Neither party contests this point. Pl. Opp. at 6. However, the courts must apply the balancing test outlined below.

**B. Balancing Test to Stay Action**

The Ninth Circuit sets out the factors that must be considered in order to issue a stay of further proceedings in an action. It requires a balancing test where the "competing interests" at issue are weighed against one another, including the damage that might result from granting a stay, the hardship that a party forced to go forward might face, and the "orderly course of justice." *Cmax, Inc. v. Hall*, 300 F.2d 265, 268 (9th Cir. 1962). The court must look at the benefit to the court of granting the stay, the prejudice to plaintiffs the stay may cause, and the prejudice to defendant if the stay is not granted. *Rivers v. Walt Disney Co.*, 980 F. Supp. 1358, 1360 (C.D. Cal. 1997); *Gray v. First Winthrop Corp.*, 133 F.R.D. 39, 40 (N.D. Cal. 1990). Additionally, "the burden is on the party seeking the stay to show that there is pressing need for delay, and that neither the other party nor the public will suffer harm from entry of the order." *Ohio Envtl. Council v. U.S. Dist. Court, S. Dist. of Ohio*, 565 F.2d 393, 396 (9th Cir. 1977).

**1. Interest of Justice and Benefits to the Court**

Courts may stay proceedings to "control the disposition of the causes on its docket with economy of time and effort for itself, for counsel, and for litigants," as long as competing interests are weighed and a balance is maintained. *Barapind v. Reno*, 72 F. Supp. 2d 1132, 1147 (E.D. Cal. 1999) (citing *Landis*, 299 U.S. at 254-55). In this case, it seems unlikely that judicial efficiency will be promoted if the court stays further proceedings in this case.

In *Filtrol*, there were two pending patent cases, one of which was in California and the other in Connecticut. *Filtrol*, 467 F.2d at 244-45. Defendants asked the district court to stay all further proceedings, but the court denied the motion. *Id.* The Ninth Circuit refused to reverse district court's denial of a stay, ruling that it was within the power of the district court to make that determination. *Id.* at 244. A district court with a justiciable controversy before it is not required to "await the outcome of a pending action in another district." *Id.* at 245; see *Blonder-Tongue Labs., Inc. v. Univ. of Ill. Found.*, 402 U.S. 313 (1971). The court in *Filtrol* found that even though the indeterminate state of the Connecticut case could have substantively affected the decision for the California case, this fact alone did not provide the court with an adequate interest to issue a stay of further proceedings to preserve judicial economy. In this case, the IRS proceedings will not result in a determination that could alter the substantive law in this case. Instead, the IRS administrative hearings will

1 only alter the amount of damages plaintiffs may seek against defendant. This is not an adequate reason to issue  
2 a stay of further proceedings in the interest of the court.

3 Defendant also cites *United Gas Pipe Line Co. v. Tyler Gas Serv. Co.*, 247 F.2d 681 (5th Cir.  
4 1957) and *United Sweetener USA, Inc. v. Nutrasweet Co.*, 766 F. Supp. 212, 218 (D. Del. 1991) in  
5 support of its motion to stay this action pending the resolution of the IRS proceedings. While the courts in those  
6 cases granted stays pending concurrent administrative agency investigations, the cases are distinguishable from  
7 the present action. In *United Gas*, the court stayed the action between the parties, pending court of appeals  
8 review of an administrative action decision on appropriate tariff rates. 247 F.2d at 681-83. That case is  
9 distinguishable because the court of appeals made an administrative review of the validity of the tariff rates.  
10 However, the IRS's determination of damages in the present action will not affect plaintiffs' ability to assert  
11 causes of action against the defendant. Rather, it will alter the amount of damages that plaintiffs seek.

12 Similarly, *United Sweetener* involved a patent case in which the court granted a stay of further  
13 proceedings pending a reexamination of the validity of the patent. 766 F. Supp. at 216. *United Sweetener*  
14 is distinguishable from the present action because the determination of the validity of the patent directly affected  
15 whether further litigation of the issue would be necessary. Here, by contrast, the determination of the damages  
16 plaintiffs owe to the IRS will not affect whether the lawsuit goes forward, again, it will impact the amount of  
17 damages.

18 As it appears that the decision to be made by the IRS regarding plaintiffs' taxes will alter the amount  
19 of damages plaintiffs can seek against defendant, a delay in further judicial proceedings is not in the interest of  
20 judicial economy, particularly because the IRS has already determined the legality of the CDS strategy. *Yong*  
21 *v. I.N.S.*, 208 F.3d 1116, 1120-21 (9th Cir. 2000) (stating that importance of judicial economy is undermined  
22 when a stay presents the possibility of an "indefinite, and potentially lengthy delay to the advancement of the  
23 case."). As both parties agree, some damages can be accurately determined in the form of fees that plaintiffs  
24 paid to E&Y and LL&S. Pl. Opp. at 5-7; Def. Reply at 2. Plaintiffs all cite damages of \$50,000 for fees paid  
25 to LL&S and between \$500,000-\$600,000 in fees paid to E&Y.<sup>1</sup> Pl. Opp. at 5. Defendant claims that  
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27 <sup>1</sup> Plaintiffs also argue that their attorney's fees constitute damages in this case. However, the  
28 court notes that this may not necessarily be the case. The "American Rule" states that "each party to a  
lawsuit must generally bear his or her own costs; in other words, the prevailing litigant cannot collect  
attorney fees from the losing litigant. All federal courts use this rule unless one of five specific exceptions to

1 plaintiffs' damages "are not legally cognizable" until the IRS investigation is complete. Mot. to Dismiss at 2.  
 2 However, defendant does not provide any support for this contention nor does it cite any authority showing  
 3 that an assessment of penalties is required for plaintiffs to seek redress from defendant. With ascertainable  
 4 damages for plaintiffs' causes of action, the court's interest in the orderly course of justice is best served by  
 5 proceeding with discovery in this action.

## 6 **2. Prejudice to Plaintiffs**

7 The court's interest in staying the proceedings is balanced against the possible prejudice to the parties.  
 8 *Cmax*, 300 F.2d at 268. Plaintiffs argue that a stay of proceedings would prejudice their ability to conduct  
 9 discovery in preparation for the litigation of this case. Pl. Opp. at 12. According to plaintiffs, out-of-state  
 10 witnesses for this action are currently available to be deposed, and staying these proceedings might increase  
 11 the difficulty of securing their testimony in the future. *Id.* Additionally, the passage of time could fade memories  
 12 relevant to this action. *Id.* The court agrees that plaintiffs access to evidence should not be impeded to wait  
 13 for a determination from the IRS that will potentially only impact the amount of damages, rather than the  
 14 substantive basis for this complaint.

## 15 **3. Prejudice to Defendant**

16 The court also considers any prejudice that defendant will suffer if the court does not grant the stay.  
 17 *Cmax*, 300 F.2d at 268. Defendant claims that it will suffer prejudice in the form of substantial litigation costs  
 18 that could be unnecessary, depending upon the determination of the IRS of plaintiffs' tax status. Mot. to  
 19 Dismiss at 6. However, plaintiffs claim they have already suffered damages. The IRS's decision will not affect  
 20 the damages that plaintiffs have allegedly incurred in the form of fees paid to LL&S and E&Y. Pl. Opp. at 5.  
 21 Even if the IRS chose to grant amnesty to plaintiffs for their use of the CDS strategy, plaintiffs argue that these  
 22 damages would still exist and this action could still go forward.

23  
 24  
 25 the rule applies. These five exceptions are: (1) statutory, when Congress specifically provides in a statute  
 26 that the prevailing litigant is entitled to attorney fees; (2) contractual, when a contract provision allows for  
 27 attorney fees in litigation on the contract, but only when the decision is based on state law; (3) when a  
 28 litigant purposely disobeys a court order; (4) when a losing litigant has acted in bad faith; and (5) when a  
 litigant recovers a common fund that benefits others." *Alyeska Pipeline Serv. Co. v. Wilderness Soc.*,  
 241 U.S. 240, 258 (1975); *See F.D. Rich v. United States ex rel Indus. Lumber Co.*, 417 U.S. 116,  
 126 (1974); *Ex rel Reed v. Callahan*, 884 F.2d 1180, 1185 (9th Cir. 1989). Plaintiffs have not asserted  
 an exception to this rule that would allow them recovery for attorney's fees.

1 Defendant merely speculates that plaintiffs' liability may be excused by the IRS. However, plaintiffs  
2 assert existing damages that are independent of the IRS's administrative investigation. Based on the arguments  
3 presented to the court, it is unclear that the IRS's failure to assess penalties would result in eliminating plaintiffs'  
4 claims against defendant. Without further evidence of prejudice, it does not appear that defendant will be  
5 disadvantaged if discovery and other proceedings go forward in this action. Defendant has the burden of  
6 proving that a stay is necessary as the moving party. *Ohio Envtl. Council*, 565 F.2d at 396. The court  
7 concludes that defendant has not met its burden of proving that there is a pressing need for delay. Balancing  
8 the factors favors permitting this action to proceed with discovery as set forth at the parties' December 10,  
9 2004 case management conference. Nevertheless, the court recognizes that the case could not proceed to trial  
10 until the full extent of plaintiffs' tax liability is understood. Thus, although the court presently declines to stay  
11 the action pending determination by the IRS of possible tax penalties to plaintiffs, defendants may bring another  
12 motion to stay at a later point in the litigation.

### 13 III. ORDER

14 For the foregoing reasons, the court, in its discretion, denies without prejudice defendant's motion to  
15 stay further proceedings in this action.

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17  
18 DATED: 7/8/05

/s/ Ronald M. Whyte

RONALD M. WHYTE

United States District Judge

1 **Notice of this document has been electronically sent to:**

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7 Counsel are responsible for distributing copies of this document to co-counsel that have not registered for  
e-filing under the court's CM/ECF program.

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9  
10 **Dated:** 7/11/05

/s/ MAG  
Chambers of Judge Whyte